

**Application for revocation of  
coverage of the South West  
Slopes and Temora  
distribution networks under  
the National Gas Access Code**

**Final Recommendation**

**September 2003**

**National Competition Council**

## Final recommendation

This document contains the National Competition Council's (the Council) final recommendations in respect of applications for revocation of coverage of the South West Slopes (SWS) natural gas distribution network (SWS network) and the Temora natural gas distribution network (Temora network) from the provisions of the *Gas Pipelines Access (New South Wales) Act 1998* (the NSW Gas Access Act). The applications seek revocation of the pipeline networks pursuant to sections 1.24 and 1.25 of the National Third Party Access Code for Natural Gas Pipeline Systems (National Gas Access Code).

**The Council's final recommendation is that coverage under the National Gas Access Code of the South West Slopes natural gas distribution network should be revoked. The Council is not satisfied that all four of the criteria in section 1.9 of the National Gas Access Code are met.**

**The Council's final recommendation is that coverage under the National Gas Access Code of the Temora natural gas distribution network should be revoked. The Council is not satisfied that all four of the criteria in section 1.9 of the National Gas Access Code are met.**

This final recommendation is divided into two parts:

**Part A**, which explains the legislative background to the National Gas Access Code; the concept of coverage under the regime and the Council's approach to the revocation criteria under the National Gas Access Code. It also examines details of the application, including specifications of the pipeline, and the structure of the natural gas industry and the state of competition in the relevant markets.

**Part B**, which contains the Council's detailed consideration of whether the SWS network and the Temora network meets each of the criteria against which revocation of coverage must be assessed (the coverage criteria).

## Abbreviations and glossary of terms

Access arrangement	A statement of policies and the basic terms and conditions that apply to third party access to a Covered Pipeline
AGA	Australian Gas Association
Application	Application for revocation of coverage of the South West Slopes natural gas distribution network and the Temora natural gas distribution network lodged by Country Energy on 4 July 2003
Council	National Competition Council
Coverage criteria	Criteria set out in section 1.9 of the National Third Party Access Code for Natural Gas Pipeline Systems
Covered pipeline	A pipeline covered under the National Gas Access Code
Duke EGP decision	<a href="#">Duke Eastern Gas Pipeline Pty Ltd (2001) ATPR ¶41–821</a>
Gas Access Acts	The Acts in each State and Territory which provide for third party access to the services of natural gas pipelines. The Acts apply the Gas Pipelines Access Law and the National Gas Access Code as law in those jurisdictions
Gas Pipelines Access Law	In conjunction with the National Gas Access Code and the Gas Access Acts, sets out provisions of the regime for third party access to the services of gas pipelines
GJ	Gigajoule, a unit of measurement for measuring the energy content of natural gas or other energy sources
GST	Goods and services tax
MSP	Moomba to Sydney Pipeline System
National Gas Access Code	National Third Party Access Code for Natural Gas Pipeline Systems

NSW Gas Access Act	<i>Gas Pipelines Access (New South Wales) Act 1998</i> . The Act which applies the National Gas Access Code to gas pipelines in New South Wales.
Pipeline	Defined in the National Gas Access Code and the GPAL as a pipe or system of pipes for transporting natural gas and tanks, machinery, etc attached to the pipes, but does not include any facilities of the upstream processing plant, or anything downstream of the connection point to the consumer
PJ	Petajoule (equal to 1,000,000 GJ or 1,000 TJ)
PJ/a	Petajoules per year
PJ/d	Petajoules per day
SWS	South West Slopes. The South West Slopes region of NSW extends from the Murray River in the south to Dubbo in the north, and from Tumut in the east to Narrandera in the west. It encompasses an area of just over 800,000 square kilometres within the Murray-Darling Basin.
Sydney Airport decision	<a href="#">Re Review of declaration of freight handling services at Sydney International Airport (2000) ATPR ¶41–754</a>
TJ	Terajoule (equal to 1,000GJ)
TJ/a	Terajoules per annum
TJ/d	Terajoules per day
TPA	<i>Trade Practices Act 1974</i>

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# **Part A–Legislative background**

## **The National Gas Access Code**

The NSW Gas Access Act applies the National Gas Access Code to gas pipelines in the New South Wales.

The National Gas Access Code entitles parties to negotiate access to the transport capacity in natural gas transmission pipelines and distribution networks which are covered by the National Gas Access Code within an independent regulatory framework. The National Gas Access Code sets out the rights and obligations of service providers, pipeline users and access seekers. It includes coverage rules, the operation and content of access arrangements, ring-fencing arrangements, information parameters, dispute resolution and pricing principles.

## **Mechanism for revoking coverage**

The National Gas Access Code allows parties to seek revocation of coverage of a pipeline under the National Gas Access Code. Applications for revocation of coverage must be made to the National Competition Council. Following consideration of issues raised in public consultations, the Council issues a draft recommendation, conducts a further public consultation process then conveys a final recommendation to the decision-maker, who decides the matter. In this case, the relevant decision-maker is the Hon. Frank Sartor MP, New South Wales Minister for Energy and Utilities. Both the Council and the Minister must consider the criteria set out in Section 1.9 of the National Gas Access Code. Those criteria are set out in the Appendix.

If the Minister decides to revoke coverage of a pipeline, the owner and operator of that pipeline are released from their obligations under the NSW Gas Access Act and the National Gas Access Code.

The NSW Gas Access Act includes a process for administrative (merits-based) review of decisions to revoke coverage: section 38 Gas Pipelines Access Law. The Australian Competition Tribunal considers applications for review.

## The revocation criteria

Under section 1.31 of the National Gas Access Code, the Council cannot recommend revocation of coverage unless it considers the pipeline in question does not meet one of the criteria set out in section 1.9 of the National Gas Access Code. From another perspective, where a pipeline does not meet all of the criteria set out in section 1.9 of the National Gas Access Code, the Council must recommend revocation of that pipeline.

The Council may recommend revocation either to the extent sought, or to a greater or lesser extent than sought in the application.<sup>1</sup>

The criteria in section 1.9 are:

- (a) **that access (or increased access) to services provided by means of the pipeline in question would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the pipeline in question;**
- (b) **that it would be uneconomic for anyone to develop another pipeline to provide the services provided by means of the pipeline in question;**
- (c) **that access (or increased access) to the services provided by means of the pipeline in question can be provided without undue risk to human health or safety; and**
- (d) **that access (or increased access) to the services provided by means of the pipeline in question would not be contrary to the public interest.**

The applicant collectively refers to both the SWS network and the Temora network as “the Network”. The Council notes that while the SWS network and the Temora network exhibit very similar characteristics, such that it will be relying on similar information in its assessment, the Council must assess each network separately against the criteria in the National Gas Access Code. Even though the applicant seeks to have coverage of both the SWS network *and* the Temora network revoked, it is open to the Council under s. 1.31 of the National Gas Access Code to make a recommendation to the Minister for revocation to a lesser extent than that described in the applications.<sup>2</sup>

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<sup>1</sup> Taking account of any part of the pipeline that is necessary to provide services that potential users may seek access to (section 1.29).

<sup>2</sup> Similarly, under s. 1.34, if the Relevant Minister “decides that Coverage of the Covered Pipeline is revoked, the Relevant Minister may do so to a greater or lesser extent than requested by the applicant if, having regard to the part of the Pipeline that is necessary to provide Services that Prospective Users may seek, the Relevant Minister considers it appropriate.”

## Process for considering the criteria

For the Council to recommend against revocation of coverage it must be affirmatively satisfied of all the matters set out in section 1.9.

AGA submitted that the Council bears a burden of proof “in relation to the imposition of intrusive access pricing regulation on infrastructure assets” (AGA 2003, p. 3). They refer to a statement from Ordover where he commented:

*For competition to thrive, regulators need to let the market processes work...to facilitate the transition to competition managed by market forces instead of regulations, maximal forbearance should be the guiding regulatory principle. The scope of regulatory remedies ought to be reduced, not expanded, as competition develops. Regulators should face a strong burden of proof to show that there is a significant risk of abuse of a substantial degree of market power before imposing regulatory restraints and burdens on the incumbent firm. (Ordover 2000, p. 5) (emphasis added)*

The Council considers that Governments have already taken these concerns into account through the coverage criteria in section 1.9. These criteria are designed to ensure that regulation is only imposed on pipelines with the ability to affect competition in dependent markets, i.e. with significant market power.

In interpreting the National Gas Access Code criteria, the Council has used general principles of statutory interpretation and has accorded primacy to the language of the coverage criteria. In addition, the Council has regard to the following matters:

1. Relevant decisions of the Tribunal. The criteria have been considered by the Tribunal in the [Duke Eastern Gas Pipeline Pty Ltd \(2001\) ATPR ¶41–821 \(Duke EGP decision\)](#).
2. The objectives underlying the National Gas Access Code.
3. Decisions of the Tribunal in relation to applications for declaration under part IIIA of the *Trade Practices Act 1974* (the TPA). This is because, apart from some minor variations (the significance of which will be discussed where relevant), the words of the coverage criteria in section 1.9 of the National Gas Access Code are the same as the words of the declaration criteria in section 44G(2) of the TPA.
4. Previous applications for coverage, and revocation of coverage, of gas pipelines considered by the Council under the National Gas Access Code. The Council has also had regard to the work of Janusz A Ordover and William Lehr, *Should Coverage of the Moomba to Sydney Pipeline be Revoked?* (Ordover and Lehr 2001), which focused specifically on East Australian Pipeline Limited’s application for revocation of coverage of two



pipelines within the Moomba to Sydney Pipeline System (MSP) under the National Gas Access Code.

It should be noted that, in their submission, the AGA states that they are unclear on what basis the Council can legitimately rely on the Ordover and Lehr analysis commissioned in relation to the MSP revocation application as a general guidance (AGA 2003, p. 2). They state that:

*[T]he AGA does not believe that the commissioned advice in that matter was appropriately sought or relied upon, or that the advice itself accurately described or assisted the process of determining coverage of assets under the National Gas Code. The continued inappropriate use of this advice as a guide to the interpretation of the coverage provisions of the National Gas Code may lead to a substantial risk of regulatory error in Council deliberations. Reliance on the advice of academic commentators as to the interpretation of the Code's coverage criteria would also appear to be unnecessary given the substantial guidance given to the Council on this matter by the Australian Competition Tribunal in the Duke Eastern Gas Pipeline Pty Ltd decision. (AGA 2003, p. 3)*

Though the work done by Ordover and Lehr was commissioned in the context of the MSP revocation application, the report proposed a generic model for analysing criterion (a): focussing on the ability and incentives open to a pipeline owner to exploit market power in a dependent market. The report draws on this framework to develop the Tribunal's approach in the [Duke EGP decision](#) into a model for assessing competitive conditions in dependent markets. The model provides a broad analytical framework that encompasses each factor identified by the Tribunal, as well as other relevant factors, and may be applied in a wide range of circumstances. Consequently the Council considers it appropriate to adopt this framework in considering whether the SWS network and the Temora network satisfies criterion (a). The Council reiterates that the Ordover and Lehr framework is wholly consistent with the Tribunal's approach, but further develops that approach by providing a robust theoretical framework that may be applied to any coverage matter under the National Gas Access Code.

This recommendation considers the criteria in a different order from that laid out in the National Gas Access Code. Conceptually, the Council considers it logical to begin with criterion (b), as it focuses on the issue of the service to which access is sought and the pipeline providing that service and asks whether that pipeline exhibits natural monopoly characteristics. Criterion (a) is wider in scope as it requires consideration of industry structure, the related but distinct markets dependent on the service and whether the service provider is able to exercise market power in those related markets because the provision of the service has natural monopoly characteristics. This approach is consistent with the approach adopted by the Tribunal in the [Duke EGP decision](#).

The process adopted by the Council for considering the criteria, in respect of both the SWS and Temora networks, can be broadly summarised as follows:

- define the service provided by means of the SWS network and the Temora network, delineate the physical assets that comprise it and identify the “provider” of the “service”;
- examine whether it is economic to develop another pipeline to provide the service. Coverage is confined to facilities exhibiting natural monopoly characteristics – that is, where for a likely range of reasonably foreseeable demand for the service, it would be cheaper for the SWS network to provide those services rather than two or more pipelines. Similarly whether for a likely range of reasonably foreseeable demand for the service, it would be cheaper for the Temora network to provide those services rather than two or more pipelines. Such an assessment is relevant to whether criterion (b) is met;
- if development of another pipeline to provide the service would be uneconomical, for the purposes of criterion (a) assess whether coverage of the service will improve the conditions or environment for competition in a dependent market. Whether the conditions for competition will be enhanced depends critically on whether the natural monopoly characteristics associated with the provision of the service confer substantial market power on the service provider that can be exercised to adversely affect competition in a dependent market(s). As part of this evaluation, dependent markets will need to be identified, as will factors affecting the ability and incentive to exercise market power to adversely affect competition in a dependent market(s). Such an assessment is relevant to whether criterion (a) is met;
- assess whether access to the service can be provided safely. This is relevant to criterion (c); and
- determine whether access would not be contrary to the public interest. This is relevant to criterion (d). This criterion comes into play if the other criteria are satisfied and enables account to be taken of other factors not raised under the other three criteria, e.g. regulatory costs involved in providing access.

## Submissions

The Council received the application on 4 July 2003. In accordance with section 1.26 of the National Gas Access Code, the Council advertised the application in *The Australian Financial Review* on 18 July 2003, and wrote to interested parties calling for submissions. The Council also published a copy of the application, and invited submissions, on its website. The Council received one submission, from the Australian Gas Association (AGA).

In accordance with section 1.26 of the National Gas Access Code, the Council released its draft recommendation on 22 August 2003 and called for submissions in relation to it. The Council received no submissions.

## The application

The applicant, Country Energy Gas Pty. Ltd. ACN 083 199 839 ([Country Energy](#)), owns and operates both the SWS network and the Temora network. The applicant seeks revocation of coverage for both networks under sections 1.24 and 1.25 of the National Gas Access Code.

## The pipeline networks

The SWS network is made up of distribution systems supplying natural gas to the towns of Walla Walla, Culcairn, Holbrook and Henty. Culcairn and Henty are located on the Olympic Highway approximately half way between Albury and Wagga Wagga. Walla Walla is approximately 25 km south west of Culcairn while Holbrook is located on the Hume Highway, 70 km north east of Albury. (Country Energy 2003, p. 1)

Natural gas is supplied to the Walla Walla distribution system from the GasNet Australia pipeline from Victoria via a gate station owned by GasNet for which Country Energy pays maintenance and access charges. Natural gas for the Henty distribution system comes from the Australian Pipeline Trust (APT) pipeline (the Interconnect) via a gate station owned by Country Energy. Culcairn and Holbrook are supplied via a gate station at Culcairn from the APT pipeline. A 32km lateral main extends from Culcairn to Holbrook. There are 68km of distribution gas mains within the towns. (Country Energy 2003, p. 1)

The Interconnect is a pipeline between Wagga Wagga and Albury/Wodonga connecting the NSW and Victorian gas networks. The portion between Wagga Wagga and Culcairn in NSW is owned by APT, and the portion running from Culcairn to Barnawartha in Victoria (which crosses the border) is owned by GasNet.

In 2001/2002 the SWS network delivered approximately 123 TJ of natural gas to 1051 customers. One large contracted customer accounted for 97TJ (79%) of this amount. Total distribution network revenue for this financial year was \$605,000. (Country Energy 2003, p. 1)

Temora is located approximately 93 km north of Wagga Wagga. In 2001/02 the Temora network delivered approximately 44TJ of natural gas to 1001 customers. One large contracted customer accounted for approximately 16TJ (36%) of this amount. Total distribution network revenue for the financial year was \$262,500. (Country Energy 2003, p. 2)

A map of the SWS network and the Temora network is in Figure 1 below.

Schedule A of the National Gas Access Code lists transmission and distribution pipelines which are covered by the requirements of the Code from

the commencement of the Code's operation. Neither the SWS network or Temora network are *not* identified in Schedule A. They became covered under the National Gas Access Code through s. 1.40 which provides:

*An extension to, or expansion of the Capacity of, a Covered Pipeline shall be treated as part of the Covered Pipeline for all purposes under the Code if the Extensions/Expansions Policy contained in the Access Arrangement for that Covered Pipeline provides for that extension or expansion to be treated as part of the Covered Pipeline.*

The pipeline networks were constructed as extensions to the AGL Gas Network. Section 7 of the AGL Gas Network access arrangement contains the extensions/expansion policy:

*All extensions and expansions carried out by AGLGN normally will be treated by AGLGN as part of the existing Covered Pipeline and will automatically be included within it. An extension includes any pipes laid in NSW in a distribution system owned and operated by AGLGN at any time during the Access Arrangement.*

The AGL Access Arrangement was approved by the Independent Pricing and Regulatory Tribunal of New South Wales (IPART) in September 2000 (IPART 2000). The SWS network and the Temora network were built and completed by AGL in 1999 and 2000 respectively. They were then purchased by Great Southern Energy from AGL in February 2001. Great Southern Energy subsequently merged with Advance Energy and NorthPower to form Country Energy in July 2001.



## Part B - Coverage criteria

### **Criterion (b) that it would be uneconomic for anyone to develop another pipeline to provide the services provided by means of the pipeline.**

#### **Background**

In analysing this criterion, the Council will:

- define the services provided by both the SWS network and Temora network; and
- assess whether it is economic to develop other pipelines (including both existing pipelines and new pipelines) to provide those services.

#### **Service**

In the [Duke EGP decision](#), the Tribunal decided that the “service” provided by means of the Eastern Gas Pipeline was a haulage service for the transport of gas between one point on the pipeline and another:

*The question of what constitutes the services provided by the pipeline is fundamentally a mixed question of fact and the proper construction of criterion (b), rather than a matter of economic analysis. Every haulage service will of necessity be from one point to another. That is the commercial service actually provided by the pipeline operator to its customers. (para 69)*

On this approach the services provided by the SWS network could be described as the transportation of natural to gas consumers in the South West Slopes area and the services provided by the Temora network could be

described as the transportation of natural gas to customers in the Temora area.<sup>3</sup>

## Conclusion on service definition

The Council considers that the service provided by the SWS network is the transportation of natural to gas consumers in the South West Slopes area and the service provided by the Temora network is the transportation of natural gas to customers in the Temora area.

## Uneconomic to develop another pipeline

In considering whether it is uneconomic to develop another pipeline, it is appropriate to have regard to pipelines that have already been developed. ([Duke EGP decision](#), para 57)

The term “develop” is sufficiently broad to encompass modifications or enhancements to existing pipelines. Thus, if an existing pipeline does not presently provide the services provided by the pipeline in question, but could economically be modified or expanded to do so, then criterion (b) is not met. This is consistent with the Tribunal’s approach in the [Duke EGP decision](#). (paras 55-57)

In the present case, the Council must therefore have regard to whether it would be uneconomic to develop either new or existing pipelines to provide the services of the SWS network and the Temora network.

## Uneconomic

The Tribunal explained the concept of uneconomic as follows:

*... if a single pipeline can meet market demand at less cost (after taking into account productive, allocative and dynamic effects) than two or more pipelines, it would be “uneconomic”, in terms of criterion (b), to develop another pipeline to provide the same services. ([Duke EGP decision](#), para 64)*

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<sup>3</sup> The Council’s Final Recommendation on the application from Roma Town Council to revoke coverage of the Roma distribution system from the provisions of the *Gas Pipelines Access (Queensland) Act 1998*, the Council defined the service as being “a gas transportation services to gas consumers in the Roma area.” (NCC 2002a, p. 15). Similar definitions were used in other revocation applications involving distribution systems – e.g. Mildura distribution system (NCC 2002b), Dalby distribution system (NCC 2000a) and Alice Springs distribution network (NCC 2000b).

The Tribunal cast the test for whether it was uneconomic to develop another pipeline “in terms of costs and benefits to the community as a whole” ([Duke EGP decision](#), para 137). By emphasising efficiency “in terms of costs and benefits to the community as a whole”, the Tribunal endorsed a ‘social’ approach to the assessment of whether development of another pipeline was uneconomic.<sup>4</sup> This approach follows from that adopted by the Tribunal in *Re Review of declaration of freight handling services at Sydney International Airport* (2000) ATPR ¶41–754 ([Sydney Airport decision](#)).<sup>5</sup>

The social approach to the test therefore takes account of all relevant costs and benefits faced by society rather than being limited to private costs and benefits faced by the party considering development of another pipeline. The Tribunal has explained the rationale for this approach as follows:

*...the uneconomical to develop test should be construed in terms of the associated costs and benefits of development for society as a whole. Such an interpretation is consistent with the underlying intent of the legislation, as expressed in the Second Reading Speech of the Competition Policy Reform Bill [which inserted Part IIIA into the Trade Practices Act 1974], which is directed at securing access to “certain essential facilities of national significance”. This language and these concepts are repeated in the statute. This language does not suggest that the intention is only to consider a narrow accounting view of “uneconomic” or simply issues of profitability.*

*... If “uneconomical” is interpreted in a private sense then the practical effect would often be to frustrate the underlying intent of the Act. This is because economies of scope may allow an incumbent, seeking to deny access to a potential entrant, to develop another facility while raising an insuperable barrier to entry to new players (a defining feature of a bottleneck). The use of the calculus of social cost benefit, however, ameliorates this problem by ensuring the total costs and benefits of developing another facility are brought to account. This view is given added weight by Professor Williams’ evidence of the perverse impact, in terms of efficient resource allocation, of adopting the narrow view. ([Sydney Airport decision](#), paras 204-205)*

Ordover and Lehr provide guidance on the social interpretation of ‘uneconomic’ in the context of the Moomba to Sydney pipeline:

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<sup>4</sup> The Tribunal in the [Duke EGP decision](#) later confirmed its social costs approach to criterion (b) when it concluded that the Eastern Gas Pipeline met criterion (b) “because it would be uneconomic in a social costs sense to develop [another pipeline] to provide the services provided by means of the [Eastern Gas Pipeline]” ([Duke EGP decision](#), para 144).

<sup>5</sup> The [Sydney Airport decision](#) was concerned with interpretation of the term “uneconomical” in the declaration criterion in Part IIIA of the Trade Practices Act. The Tribunal in the Duke Eastern Gas Pipeline case stated that nothing turned on the difference between the term “uneconomic” in criterion (b) and the term “uneconomical” in Part IIIA of the Trade Practices Act ([Duke EGP decision](#), para 58).



*When [criterion (b)] is met, the total cost of transporting gas is minimized (and the goal of economic efficiency is served) when the activity is undertaken by one firm rather than by two or more firms. In the instant case, firms demanding transportation of natural gas between the production fields in Cooper Basin and the retail markets in NSW/ACT could not efficiently develop another pipeline that could compete with MSP without the overall cost of gas transport increasing. Such wasteful duplication of assets would engender inefficiencies to the detriment of the consuming public. Therefore, when criterion (b) is satisfied, it is efficient for firms wishing to ship gas between Cooper Basin and the NSW/ACT retail markets to avail themselves of the services provided by the MSP rather than constructing another pipeline. Coverage, if mandated, assures third parties access to the MSP. (Ordover and Lehr 2001, p.6)*

Noting the findings of the Tribunal and the views of Ordover and Lehr, the Council considers that criterion (b) is satisfied if a single pipeline can satisfy demand for relevant services at lower cost than two or more pipelines. The pipeline is then a natural monopoly<sup>6</sup>, and competition between two or more pipelines offering the same services would be inefficient. (Ordover and Lehr 2001, p.4)

Thus, for the purpose of criterion (b), a natural monopoly exists if for a likely range of reasonably foreseeable demand it is always cheaper for a single pipeline to provide the service under consideration rather than multiple pipelines. In determining whether such a natural monopoly exists the Council is required to:

- determine the reasonably foreseeable demand for the service provided by the SWS network and the Temora network; and
- assess whether the SWS network and the Temora network can serve the reasonably foreseeable demand for their respective services at lower costs than two or more pipelines.

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<sup>6</sup> Ordover and Lehr 2001 provide the following technical description of “natural monopoly” at p.4: Formally, a provision of a particular product or service is a natural monopoly if, over the entire relevant range of outputs, the firms’ cost function is subadditive. A cost function  $C(q)$  is subadditive at  $q$  if it is always cheaper to produce a vector of outputs,  $q$ , in a single firm than by partitioning the output among two or more firms. For further discussion of these technical characteristics, see Sharkey, William, *The Theory of Natural Monopoly*, Cambridge University Press: Cambridge, (1982) and W J Baumol, J C Panzar, and R D Willig, *Contestable Markets and the Theory of Industry Structure*, HBJ Publishers: New York (1982).

## Demand for natural gas in the South West Slopes region and the capacity of the SWS network to provide for it

The application notes that the SWS network currently services 1051 customers consuming a total of 123.2 TJ/pa (Country Energy 2003, p. 1), with 1 customer accounting for 97.6TJ/pa of that amount. The applicant notes that the SWS network has “significant levels of spare capacity”. (Country Energy 2003, p. 5)

The Council has limited information on forecast demand for gas in the South West Slopes region of New South Wales in the future. However, the applicant notes that, while they are continuing to seek opportunities for additional gas sales in order to increase the capacity used, they state that the market is not expected to grow significantly. This is because the majority of potential "line of main" conversions has already occurred and future growth in customer numbers is expected to be very low, consistent with general population and household growth in the serviced towns (Country Energy 2003, pp. 3-4). The applicant states that these growth figures are expected to be “very low, averaging below half of one percent per annum over the next ten years” (Country Energy 2003, p. 1). As a result:

*[g]rowth in contract customer numbers and load is also likely to be low in the foreseeable future as the rural economy struggles to recover from the effects of the drought. Country Energy is not aware of any new contract customers, or planned increases in usage from existing customers. (Country Energy 2003, p. 4)*

Attempts to increase gas sales are also effected by other energy sources, in particular LPG, electricity, and wood and wood waste. (Country Energy 2003, p. 5)

Given the significant excess capacity in the SWS network and the limited prospects for growth in demand for natural gas from it , the Council considers that the SWS network has sufficient capacity and ability to meet demand for natural gas in South West Slopes region for the foreseeable future.

## Demand for natural gas in the Temora region and the capacity of the Temora network to provide for it

The application notes that the Temora network currently services 1001 customers consuming a total of 43.6 TJ/pa (Country Energy 2003, p. 2), with 1 customer accounting for 15.6TJ/pa of that amount. The applicant notes that the Temora network has “significant levels of spare capacity”. (Country Energy 2003, p. 5)

The Council has limited information on forecast demand for gas in the Temora region in the future. However, the applicant notes that, while they

are continuing to seek opportunities for additional gas sales in order to increase the capacity used, they state that the market is not expected to grow significantly. This is because the size of the market is unlikely to change in the future because “the initial peak in connections has already occurred, with the maximum increase in household growth over the next ten years forecast to average around 1% per annum” (Country Energy 2003, p. 2). Therefore:

*[g]rowth in contract customer numbers and load is also likely to be low in the foreseeable future as the rural economy struggles to recover from the effects of the drought. Country Energy is not aware of any new contract customers, or planned increases in usage from existing customers. (Country Energy 2003, p. 4)*

Attempts to increase gas sales are also effected by other energy sources, in particular LPG, electricity, and wood and wood waste. (Country Energy 2003, p. 5)

Given the significant excess capacity in the Temora network and the limited prospects for growth in demand for natural gas from it, the Council considers that the Temora network has sufficient capacity and ability to meet demand for natural gas in Temora region for the foreseeable future.

## Developing a new pipeline

Investment in gas pipelines is, in economic language, ‘sunk’. That is, the investment is fixed or committed, and if the investment is a failure, little or none of it can be retrieved. This means that entry and exit costs to provide these services are high, and that incremental or gradual entry – a common form of entry in other industries – is not feasible in gas transmission and distribution.

It is not uncommon for existing pipelines to have spare capacity. From a pipeline company’s point of view, it is often prudent to cater to the unpredictability of future requirements by building a larger capacity pipeline. This is because the costs of laying a new pipeline rise slowly compared with increases in the capacity of that pipeline. In other words, it is much less expensive – per unit of capacity – to lay a large capacity pipeline than a small capacity pipeline.

The Council notes that gas pipelines typically have high construction costs and low operating costs, making the marginal cost of transporting a unit of gas very low. Moreover, up to the point of fully expanded capacity, average costs of transport per unit of gas decline. These features are indicative of natural monopoly characteristics. In lay terms, it is almost always cheaper to transport gas through existing pipelines (if spare capacity exists or can be added) than it is to build another pipeline to transport gas. In the case of distribution systems, there are additional obstacles of urban town planning and environmental restrictions.

In summary, therefore, it is generally not economic to develop another pipeline where an existing pipeline has spare capacity (or can develop it through greater compression and/or looping). Having said this, the Council recognises it will always be necessary to consider the facts of particular pipelines.

In considering the services of the SWS network and the Temora network, the Council has found no evidence to suggest that they deviate from the typical characteristics noted above. The Council notes in this regard that both networks are currently servicing only a fraction of forecast load, suggesting that the most efficient way of satisfying any future expansion in demand would be through the services of the existing networks.

The Council also notes that the applicant believes that this criterion is satisfied, as it states that it does not dispute that “it is currently likely to be uneconomic in a social cost-benefit sense for the pipelines in question to be duplicated”. (Country Energy 2003, p. 2)

## Develop existing pipelines

As noted by the Tribunal in the [Duke EGP decision](#), criterion (b) includes consideration of whether it would be economic to develop another existing pipeline to provide the services provided by the SWS network and the Temora network. On the evidence before the Council, it does not appear that there is another pipeline that could be developed to provide a substitute service to that of the SWS network or the Temora network.

## Conclusion on criterion (b)

The Council is affirmatively satisfied that, for the likely range of reasonably foreseeable demand for the transportation of gas on the SWS network, it is more efficient, in terms of the costs and benefits to the community as a whole, for the SWS network to provide those services rather than for those services to be provided by more than one pipeline.

The Council is therefore satisfied that criterion (b) is met for the SWS network.

The Council is affirmatively satisfied that, for the likely range of reasonably foreseeable demand for the transportation of gas on the Temora network, it is more efficient, in terms of the costs and benefits to the community as a whole, for the Temora network to provide those services rather than for those services to be provided by more than one pipeline.

The Council is therefore satisfied that criterion (b) is met for the Temora network.

**Criterion (a) that access (or increased access) to services provided by means of the pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the pipeline.**

## **Background**

Criterion (a) specifies that coverage is only warranted if regulated access would create the conditions or environment for improving competition in at least one market other than the market for the services of the gas pipeline.

To conclude that a pipeline meets criterion (a), the Council must be satisfied that:

- (a) the service to which access is sought is not in the same market as the market or markets in which competition is promoted; and
- (b) access would promote a more competitive environment in that other market.

## **Market**

In considering market definition, the Council is guided by the decisions of the Federal Court, the Tribunal and the High Court in their consideration of markets for the purposes of Part IV; as well as the Tribunal's and the Courts' consideration of Part IIIA.

The Tribunal has defined "market" in the following way:

*"A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them (if there is no close competition there is of course a monopolistic market). Within the bounds of a market there is substitution - substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive. ... Whether such substitution is feasible or likely*

*depends [on a number of factors] ... in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction?" (Re Queensland Co-operative Milling Association Ltd (1976) 25 FLR 169 at 190).*

This view of market has been accepted by the High Court in the Queensland Wire decision (*Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Ltd and Another* (1989) 167 CLR 177) and was adopted by the Tribunal in the [Sydney Airport decision](#) and the [Duke EGP decision](#).

## Dimensions of markets

The relevant dimensions of markets include the following.

- The product market, that is the types of goods and services in a market. Separate product markets exist if their respective products are not substitutable in demand or supply. Products are demand substitutes (and are therefore in the same product market) if consumers will substitute one product for the other following a small but significant change in their relative prices. Substitution in supply occurs when a producer can readily switch its assets from producing one product to another. Market entry can be distinguished from supply side substitution by the requirement for significant investment in production, distribution or promotion.
- The functional market. Functional market definition focuses on the different steps in a production process. In defining functional markets, the Council has had regard to the Tribunal's approach to functional market delineation in the [Sydney Airport decision](#)<sup>7</sup> which is consistent with the approach used by the High Court in *Queensland Wire* and developed by Mr Henry Ergas (Ergas 1997, pp. 1 - 3). The Council considers that the two following conditions must be satisfied before markets can be regarded as functionally separate.
  - The layers at issue must be separable from an economic point of view (*economically separable*). This involves an assessment as to whether the transaction costs in the separate provision of the good or service at the two layers are so large as to prevent such separate provision from being feasible. In effect, to be in different markets, vertical integration must not be inevitable.
  - Each layer must use assets sufficiently specific and distinct to that layer such that the assets cannot readily produce the output of the other layer (*economically distinct*). In effect, supply side substitution must not be so readily achievable as to unify the field of rivalry between the two layers.

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<sup>7</sup> See paras 91 – 99.

Markets may be functionally separate even though there is a *one for one* relationship, that is to say, perfect supply and demand side complementarity. However, where complementarity is associated with economies of joint production or consumption such that separate provision or consumption was not economically feasible, the services will not be in functionally separate markets.

- The geographic dimension of the market. This refers to the area covered by the market such as national, intrastate or regional markets. The reference to ‘other markets’ in criterion (a) includes markets outside Australia.
- The temporal dimension of the market. refers to the period over which substitution possibilities should be considered. The temporal dimension may impact on how broadly the market is defined. With a longer time dimension, the ability of consumers to substitute to other sources of supply in response to a price increase is likely to be greater. For example, with a sufficiently long time dimension, gas consumers can switch to alternative fuels (e.g., oil) or sources of power (e.g., electricity) in response to an increase in the price of natural gas. The Council has considered each of these factors in its assessment of criterion (a).

## Market analysis

In regard to the SWS network, the applicant submits that the relevant primary downstream market is:

- markets in the gas industry, including the markets of gas exploration, production, processing, transmission and retailing; and
- other markets such as those in which the SWS network customers compete. (Country Energy 2003, p. 3)

In regard to the Temora network, the applicant submits that the relevant primary downstream market is:

- markets in the gas industry, including the markets of gas exploration, production, processing, transmission and retailing; and
- other markets such as those in which the Temora network customers compete. (Country Energy 2003, p. 3)

In recent recommendations on applications for revocation of coverage for gas distribution systems in Mildura, Dalby and Roma, the Council concluded that the relevant downstream markets were the markets for the provision of natural gas to meet the demands of gas consumers in the respective towns. Similarly, the Council considers that the relevant downstream market in the current case is the market for gas sales in the areas serviced by the SWS network and the Temora network. The Council does not consider it necessary

to narrow the market for gas sales to a particular type or types of customer (e.g., on the basis of type of premises or good or service produced).

The Tribunal has previously considered that the relevant product market is the market for natural gas; and there are a number of functional levels in the natural gas market including transmission, exploration, sales and distribution ([Duke EGP decision](#), para 77). In line with these conclusions, the Council considers that the market for natural gas distribution is separate from the market for natural gas sales.

## Conclusion on markets

The Council is satisfied that the market in which the gas distribution services provided by the SWS network and the Temora network exist, is separate from the market for gas sales in the South West Slopes and Temora regions respectively.

## Promotion of competition

Criterion (a) requires consideration of whether regulated access under the National Gas Access Code would promote competition in a dependent market.

The notion of competition is central to Australian trade practices law. Competition is a dynamic process, generated by market pressure from alternative sources of supply and demand. In this sense, competition expresses itself as rivalrous market behaviour. The key feature of effective competition is that no one seller (or group of sellers) or buyer (or group of buyers) has sustained and substantial market power.

The Federal Court, in the QCMA decision, described “competition” as follows:

*“Competition expresses itself as rivalrous market behaviour ... In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.*

*Competition is a process rather than a situation. Nevertheless whether firms compete is very much a matter of the structure of the markets in which they operate. (Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Limited (1976) 25 FLR 169,188).*

Promotion of competition refers to improving the opportunities and environment for competition such that competitive outcomes are more likely to occur. In considering s. 44H(4)(a) of the TPA, on which criterion (a) of the National Gas Access Code is based, the Tribunal in the [Sydney Airport decision](#) made the following observations on the promotion of competition test:



*The Tribunal does not consider that the notion of “promoting” competition in s 44H(4)(a) requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased. Rather, the Tribunal considers that the notion of “promoting” competition in s 44H(4)(a) involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.*

*We have reached this conclusion having had regard, in particular, to the two stage process of the Part IIIA access regime. The purpose of an access declaration is to unlock a bottleneck so that competition can be promoted in a market other than the market for the service. The emphasis is on “access”, which leads us to the view that [section] 44H(4)(a) is concerned with the fostering of competition, that is to say it is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that the Tribunal considers that the promotion of competition involves a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial. ([Sydney Airport decision](#), paras 106 - 107)*

The Tribunal added:

*The Tribunal is concerned with furthering competition in a forward looking way, not furthering a particular type or number of competitors. In this matter, therefore, the Tribunal must be reasonably satisfied that declaration would, looking forward, improve on the competitive conditions in the relevant markets that are likely to exist as a result of the [Sydney Airports Corporation Limited] tender process as compared with a situation where there was no declaration. ([Sydney Airport decision](#), para 108)*

The Tribunal in the [Duke EGP decision](#) endorsed this approach:

*The Tribunal [in the Sydney Airport decision] concluded that the TPA analogue of criterion (a) is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market. It is in this sense that the notion of promotion of competition involves a consideration that if the conditions or environment for improving competition are enhanced, then there is a likelihood of increased competition that is not trivial. We agree. (para 75)*

Consistent with the Tribunal’s findings, the Council concludes that “promotion of competition” refers to improving the environment or conditions for competition. This may, for example, involve removing barriers to entry that inhibit opportunities for competition. Similarly, it may involve removing

barriers that limit the ability of small players to expand their level of operations within a market.

In the [Duke EGP decision](#), the Tribunal found that the ability to exercise market power in a dependent market is a key factor in determining whether coverage would promote competition:

*Whether competition will be promoted by coverage is critically dependent on whether EGP has power in the market for gas transmission which could be used to adversely affect competition in the upstream or downstream markets. There is no simple formula or mechanism for determining whether a market participant will have sufficient power to hinder competition. What is required is consideration of industry and market structure followed by a judgment on their effects on the promotion of competition. ([Duke EGP decision](#), para 116)*

Ordover and Lehr describe the economic definition of market power as follows:

*In economics, market power is defined as the ability to profitably raise prices above marginal cost. Any firm – other than a firm operating in a perfectly competitive market – can have, in principle, some ability to raise price above marginal cost: all that is required is that the firm faces a downward-sloping demand curve. Indeed, under some cost conditions, pricing at marginal cost would ruin the firm and is thus a precondition for financial viability.<sup>8</sup> Regulatory concerns arise only if the firm possesses significant and durable market power leading to prices that substantially deviate from proper economic costs and which generate persistent supracompetitive returns. When a firm possesses substantial and durable market power, it is often said to possess "monopoly power." Additionally, a firm with market power may have both an incentive and ability to engage in market strategies designed to protect its monopoly profits and power to the detriment of competition and consumers.<sup>9</sup> (Ordover and Lehr 2001, p.7)*

## With or without coverage

As has been noted, the Tribunal found in the [Sydney Airport decision](#) that the “promotion of competition” test requires an assessment of whether regulated access would improve the competitive conditions in relevant markets,

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<sup>8</sup> “For example, marginal cost pricing will fail to recover total costs if there are substantial fixed costs.”

<sup>9</sup> “Of course, firms generally strive to protect or enhance their market positions. Such quest for profits and market share is, indeed, an engine of competition and should not be discouraged. See, for example, Jeffrey Church and Roger Ware, *Industrial Organisation*, Irwin/McGraw Hill, Boston (2000).”

compared with the conditions likely to exist absent regulation. ([Sydney Airport decision](#), para 108)

The Tribunal endorsed this approach in the [Duke EGP decision](#):

*... the question posed by criterion (a) is whether the creation of the right of access for which the Code provides would promote competition in another market. The enquiry is as to the future with coverage and without coverage. We agree with the approach adopted by the Tribunal in Sydney International Airport in this respect. The Tribunal must have regard to the position as it now stands, insofar as it provides a reliable guide to the future without coverage. Thus, (assuming the present is a reliable guide to the future without) account is to be taken of the EGP as an open access pipeline, and of any other pipelines supplying the upstream or downstream gas markets, in order to determine whether coverage of the EGP would promote competition in at least one of those markets. ([Duke EGP decision](#), para 74)*

## Council's consideration

The Council needs to consider whether Country Energy, as owner and operator of the SWS network has the ability and incentive to exercise its market power in the market for gas sales in the South West Slopes area. Similarly consideration needs to be given to whether Country Energy, as owner and operator of the Temora network has the ability and incentive to exercise its market power in the market for gas sales in the Temora area.

In the [Duke EGP decision](#), the Tribunal considered a range of factors in assessing whether the Eastern Gas Pipeline could exercise market power in a dependent market, including:

- the commercial imperatives on Duke Energy to increase throughput, given the combination of high capital costs, low operating costs and spare capacity;
- the countervailing market power of other participants in the dependent markets;
- the existence of spare pipeline capacity; and
- competition faced by Duke Energy from alternatives to the use of the Eastern Gas Pipeline in the dependent markets (i.e., the services of the Moomba to Sydney Pipeline and the Interconnect).

Following its consideration of these factors, the Tribunal concluded that the Eastern Gas Pipeline did not have market power in the dependent markets.

The Tribunal did not indicate that the list of factors on which it based its decision was necessarily an exhaustive one for assessing competitive

conditions in dependent markets in all instances. Rather, the Tribunal focussed on pertinent aspects of industry and market structure of specific relevance to the Eastern Gas Pipeline.

There are two plausible reasons why a service provider with monopoly power over the provision of a service (provided by means of a pipeline) might use this power to impact competition in a dependent market or markets. First, it may seek to do this to exploit its monopoly position in the provision of the service. Second, insofar as it is (or plans to be) vertically integrated, it may seek to extend, protect or exploit whatever market power it may have in a dependent market or markets.

It is only where the service provider has both the incentive and ability to use its presumed monopoly power to affect adversely competition in the dependent market(s) that coverage will be likely to improve the conditions for competition in the market(s). The Ordovery and Lehr model proposes three lines of inquiry for assessing whether a pipeline owner has the incentive and ability to exploit market power (i.e., inhibit competition) in upstream and/or downstream markets. The lines of inquiry are:

- (a) the ability of the relevant pipeline owner to charge monopoly prices for transport services;
- (b) the ability of the relevant pipeline owner to engage in explicit or implicit price collusion; and
- (c) other incentives and opportunities for the relevant pipeline owner to distort competition in adjacent markets.

Whether the service provider will engage in the conduct described above depends upon it having both the ability and incentive to do so.

The service provider may have an incentive to engage in strategies designed to impact pro-competitively on competition in the dependent market(s). For example, if the service provider has no ownership interests in the dependent market(s) and if the pipeline has excess capacity, it may be profit maximising to promote increased competition in the dependent market(s) to reduce margins and prices in the dependent market(s) and increase incremental demand for the services provided by the pipeline. In these circumstances, the service provider will not have an incentive to engage in the conduct described above.

The applicant argues that it does not have the ability or incentive to exercise market power to hinder competition in the any of the markets of gas exploration, production, processing, transmission and retailing, servicing either the SWS network or the Temora network for four main reasons:

- (1) existence of competing energy sources;
- (2) many of its current customers have a limited ability to pay even the regulated prices;

- (3) there is significant levels of spare capacity in both the SWS network and the Temora network; and
- (4) open and non discriminatory third party access already exists under all of Country Energy's current uncovered distribution networks, and this would occur if coverage of the SWS network and/or the Temora network is revoked.

### (1) *Competing energy sources*

The applicant argues that both the SWS network and the Temora network display the “typical characteristics of small-town gas markets” including strong competition in the retail market from other energy sources, in particular LPG, electricity, and wood and wood waste. It states that marketing of LPG in the South West Slopes area and in the Temora area, has been “aggressive”, and both Origin Energy and AGL compete in this market. The result for the applicant is that:

*This competition from other fuel sources means that Country Energy has no market power in the energy market and would be unable to sustain increased prices even if it wished to. (Country Energy 2003, p. 5)*

The applicant relies on a statement of the Australian Competition Tribunal in the [Duke EGP decision](#), where the Tribunal noted that gas infrastructure in regional areas where gas penetration is growing face pressures from other fuel sources, such as LPG and electricity. The Tribunal took the view that these pressures represented a sufficient constraint on the price of gas in these townships and that regulated third party access, and price regulation, was unnecessary. The Tribunal noted that in relation to gas infrastructure in regional energy markets:

*the ability to monopoly price would be restricted because potential users have bargaining power, the costs of conversion to enable use of gas are significant ... In other words, the prices of existing forms of energy will be a countervailing force on the price of gas and pipeline services. (para 129)*

The AGA supported this, stating that the SWS network and the Temora network are “characteristic small regional gas markets”, characterised by:

- strong inter-fuel competition from incumbent energy sources (i.e. electricity, LPG, wood);
- low initial uptake of natural gas by residential customers due in part to cost of conversion of appliances;
- small number of large industrial customers;

- gas transportation costs are a significant proportion of the final cost of gas supply. (AGA 2003, p. 4)

The AGA argues this means that the owners have strong incentives to maximise throughput of gas in the system to:

- win customers from competing energy sources;
- lower the gas transportation component of the delivered price of gas which is largely driven by fixed network costs by growing the total gas market;
- seek to improve network utilisation by lowering spare capacity. (AGA 2003, p. 4)

### *(2) Ability to pay*

The applicant argues that some of its current customers have a limited ability to pay the regulator-approved amount, such that it “has had to discount prices below that approved by the regulator in order to ensure utilisation of the pipelines” (Country Energy 2003, p. 5). For the applicant this represents a strong constraint on its ability to use any presumed market power to increase prices above competitive levels.

### *(3) Spare pipeline capacity*

The applicant argues that both the SWS network and the Temora network are currently characterised by significant levels of spare capacity. In order to optimise its profit position it argues that it has a strong commercial incentive to increase throughput to offset the fixed asset costs of providing services. With low per unit operating costs, the applicant does not consider it to be in its interests to increase prices and restrict throughput. (Country Energy 2003, p. 5)

### *(4) Current third party access*

The applicant states that it is the owner of gas distribution networks that serve a number of other towns in the region, including Bombala, Cooma, Tumut, Adelong and Gundagai. These distribution networks serve slightly more customers than either the SWS network or the Temora network and are not covered under the National Gas Access Code. For these networks, the applicants offers access to all access seekers on terms and conditions broadly similar to those offered to access seekers for its Wagga Wagga distribution system (a covered pipeline with an access arrangement in place).

If revocation of coverage of the SWS network and/or the Temora network was granted, the applicant states that it:

*intends to keep offering access to third parties, in a similar manner to the access offered on its existing uncovered networks. Access seekers*

*will therefore have the same level of access to the pipelines as at present.* (Country Energy 2003, p. 4)

The applicant also notes that it has not received a single application for access to the SWS network or for access to the Temora network since they were acquired. AGA believes that such requests are unlikely in the future given that most gas users are unlikely to have sufficient incentives to negotiate separately with alternative gas suppliers. (AGA 2003, p. 5)

As noted above, the Council considers that, in certain circumstances, it may be profit maximising to promote increased competition in the dependent market(s) to reduce margins and prices in the dependent market(s) and increase incremental demand for the services provided by the pipeline. The Council's final recommendation on the application for revocation of the Roma distribution system concluded, relying on the statement of the Tribunal in the [Duke EGP decision](#) concerning regional markets, that the Roma Town Council did not have the ability or incentive to exercise market power to hinder competition because of the very small size of the market. Nor did it have the ability or incentive to use its vertical linkages to distort competition in the downstream market, as it was in its interest to promote increased throughput into the gas sales market. The Council came to a similar conclusion in its final recommendation on the application for revocation of coverage of the Mildura Distribution System.

The Council notes the existence of significant spare capacity in the SWS network and the Temora network, the close competition provided by competing fuel sources and the marginal profitability of these networks. The Council considers that these circumstances suggest that Country Energy has a strong incentive to maximise throughput of gas in the pipeline.

The potential for new participants to enter the gas sales market in the South West Slopes region and in Temora, with or without coverage, appears limited. Market entry appears likely to be constrained by the small and slow-growing industrial base in the area, lack of residential demand for natural gas and strong competition from competing fuel sources. The applicants note that no potential users have requested access to the SWS network and the Temora network, and consider that any future requests are unlikely. (Country Energy 2003, p. 5)

The Council notes that Country Energy has vertical linkages in the gas sales markets in the South West Slopes and Temora areas. It is the owner and operator of the SWS network and the sole gas retailer in the downstream market. Country Energy has orally advised the Council that with regard to the Temora network, AGL and Origin Energy also retail gas into the town.

With regard to the SWS network, in general, the Council is concerned that such a vertically integrated service provider may seek to extend, protect or exploit whatever market power it may have in the gas transport market into the downstream market. However, in its final recommendation on the application for revocation of the Roma distribution system, the Council accepted the views of the applicant and other interested parties that, due to

the small loads used by consumers and the high transaction costs involved, it was uneconomical for individual gas users to negotiate contracts directly with producers to buy gas and then seek access to transmission pipelines and the Roma gas distribution system in order to have the gas delivered to those users. Therefore, continued coverage would not promote competition in the market for gas sales to consumers in the town of Roma. This was supported by statements that no third parties had ever sought access, or desired to seek access, to the Roma distribution system. (NCC 2002a, p. 26)

The Council considers that the SWS network display similar characteristics. In particular, the small total load and high transaction costs suggest that it would be uneconomical for individual customers to negotiate each component of a delivered gas tariff with the various service providers.

It also appears highly unlikely that continued coverage of the SWS network and the Temora network would promote competition in upstream markets. The small existing load and indifferent outlook for growth in the market for gas sales in the South West Slopes region and the Temora region suggest that continued coverage of the SWS network and the Temora network would be most unlikely to be a trigger for greater competition in upstream markets.

## **Conclusion on criterion (a)**

The Council considers, relying on the statement of the Tribunal in the [Duke EGP decision](#) concerning regional markets, that Country Energy does not have the ability or incentive to exercise market power to hinder competition in the downstream markets because of the very small size of the markets and because it is in its interest to promote increased throughput into the gas sales market.

The Council considers that continued coverage of the SWS network and the Temora network is unlikely to promote competition in the downstream markets for natural gas sales in the South West Slopes region and the Temora region.

The Council is therefore not satisfied that criterion (a) is met for the SWS network.

The Council is therefore not satisfied that criterion (a) is met for the Temora network.



## **Criterion (c) that access (or increased access) to the services provided by means of the pipeline can be provided without undue risk to human health or safety**

### **Background**

The rationale for this criterion is that the National Gas Access Code should not be applied to pipelines where access might pose an undue risk to human health or safety.

In regard to the SWS network and the Temora network, the applicant argues that “there are no human health or safety issues associated with providing access to the pipelines.” (Country Energy 2003, p. 2)

### **Conclusion on criterion (c)**

There is no evidence before the Council to suggest that regulated access cannot be provided to the SWS network or the Temora network without undue risk to human health or safety. Consequently, the Council is satisfied that this criterion is met for both the SWS network and the Temora network.

## **Criterion (d) that access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest**

### **Background**

The Tribunal in the [Duke EGP decision](#) considered that:

*... criterion (d) does not impose an additional positive requirement which can be used to call into question the results obtained by the application of pars (a), (b) and (c). Criterion (d) accepts the results derived from the application of the other criteria, but enquires whether there are any other matters which lead to the conclusion that coverage would be contrary to the public interest (para 145).*

One matter of public interest is whether any benefits of coverage, such as cheaper prices and more efficient use of resources, are outweighed by regulatory or compliance costs. Other matters of public interest include environment considerations, regional development, and equity.

While no attempt to list public interest considerations can be exhaustive, matters which might be considered include the open-ended list of items in clause 1(3) of the CPA:

- ecologically sustainable development;
- social welfare and equity considerations, including community service obligations;
- government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;
- economic and regional development, including employment and investment growth;
- the interests of consumers generally or of a class of consumers;
- the competitiveness of Australian businesses; and
- the efficient allocation of resources.

Other relevant matters may include impending access regimes or arrangements, national developments and the desirability for consistency across access regimes, relevant historical matters and privacy.

The AGA submits that the Council “appears to regard [this criterion] as only a residual provision of the coverage criterion” and that they do “not consider that there is any support for reading the public interest criterion in this way. The public interest criterion should be applied as a substantive and independent step in assessments of coverage or revocations”. (AGA 2003, p. 4)

The Council does not consider that criterion (d) is a “residual provision” of the criteria. As has been stated, the Council must be affirmatively satisfied that the pipeline meets all of the criteria before it can recommend against revocation. However, the Tribunal has stated, as quoted above, that criterion (d) does not impose an additional positive requirement which can be used to call into question the results obtained by the application of criteria (a), (b) and (c). Criterion (d) is not concerned with addressing the concerns to which criteria (a) to (c) are directed but enquires whether there are any other matters which lead to the conclusion that coverage of the pipeline would not be in the public interest.

In considering whether the costs of coverage outweigh the benefits, the Council notes that because criterion (f) is phrased in the negative, a recommendation to revoke coverage where criteria (a) to (e) are satisfied would require that the costs of coverage must outweigh the benefits of regulating natural monopoly services with substantial market power. The extent of these benefits depends on the likely effect on competition in related markets of regulating natural monopoly services; issues considered under criterion (a).

## The application

The applicant argues that access to the SWS network and the Temora network via an Access Arrangement under the National Gas Access Code would be contrary to the public interest as the costs of providing access would exceed the public benefits. (Country Energy 2003, p. 7)

- The administrative costs incurred by IPART (estimated at \$100,000) and regulatory costs incurred by the applicant (estimated at \$200,000 over a five year regulatory cycle) likely to be incurred in the preparation of, and compliance with, a new stand-alone access arrangement for each network.
- These costs would be recovered from end-users. The applicant estimates that for the SWS network and the Temora network *combined*, this amounts, in the context of a total combined annual throughput of 167 TJ and adding Country Energy's direct costs to assumed IPART costs of \$100,000 is equivalent to: \$1.80 per GJ of throughput; or \$146 per customer (Country Energy 2003, p. 7).<sup>10</sup> The result would be to place

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<sup>10</sup> The Council notes that this is an aggregated figure for both the SWS network and the Temora network combined. The Council cannot be sure of what the costs would

natural gas at a “competitive disadvantage compared to alternative fuel sources such as LPG and wood which are not regulated, or electricity for which regulatory costs are spread over a much greater customer base”.

- No other party has requested access to either the SWS network or the Temora network and the applicant believes no such request is likely in the medium term. At any rate, the applicant intends to continue to provide third party access to both networks, as it is the most commercially efficient way of dealing with them (Country Energy 2003, pp. 7-9)

AGA’s submission supports Country Energy’s application in relation to this criterion. It estimates that revocation would save, at a minimum, an average of \$97 per customer per five years. (AGA 2003, p. 6)

## **Conclusion on criterion (d)**

The Council accepts that there are regulatory and compliance costs associated with coverage under the National Gas Access Code.

It is necessary for the Council to determine whether the benefits of access outweigh the costs. On the evidence currently before the Council, no third party intends to seek access to the SWS network or the Temora network, and there would appear to be no benefit from regulated access which the Council could weigh against the costs associated with regulated access. The most significant benefit of continued coverage is the possibility that access to the SWS network and the Temora network will facilitate competition. In its consideration of criterion (a), the Council has concluded that continued coverage of both these networks would not promote competition in the downstream markets.

Accordingly the Council is satisfied that continued coverage of the SWS network is contrary to the public interest. The Council is therefore satisfied that criterion (d) is not met.

The Council is also satisfied that continued coverage of the Temora network is contrary to the public interest. The Council is therefore satisfied that criterion (d) is not met.

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be for each network separately. It may be possible for IPART to deal with both Networks in the one access arrangement, thus reducing the cost component.

## **Appendix 1: Submissions to the Council**

The following submissions were made to the Council:

<b>No.</b>	<b>Submission</b>	<b>Date</b>
1.	Australian Gas Association	8 August 2003

## Appendix 2 - Coverage criteria in the National Gas Access Code

Section 1.9 of the National Third Party Access Code for Natural Gas Pipeline systems provides:

*Subject to sections 1.4(a) and 1.10. the NCC must recommend that the Pipeline be covered (either to the extent described, or to a greater or lesser extent than that described in the application) if the NCC is satisfied of all of the following matters, and cannot recommend that the Pipeline be Covered, to any extent, if the NCC is not satisfied of one or more of the following matters:*

- (a) that access (or increased access) to services provided by means of the Pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the Pipeline;*
- (b) that it would be uneconomic for anyone to develop another Pipeline to provide the services provided by means of the Pipeline;*
- (c) that access or increased access to the services provided by means of the Pipeline can be provided without undue risk to human health or safety; and*
- (d) that access (or increased access) to the services provided by means of the Pipeline would not be contrary to the public interest.*

## References

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